living increase that the CPI stands for. Tables 7 and 8 (below) summarize the effects of alternative approaches to modifying the Social Security benefit indexing mechanism.

The "Rental Equivalent" Modified Index

One solution to the housing treatment in the CPI is to tie benefit increases instead to a modified price index that uses a rental equivalent for housing costs. This approach was suggested in the 1982 Carter Administration budget. This modified "rental equivalent index" is now being published by the Bureau of Labor Statistics (BLS). It measures the cost of living in an owner-occupied house by the amount that equivalent accommodations would cost on a rental basis. All of the other components of this index, however, are the same as those in the CPI. This index, if it were implemented for the June 1981 benefit increase, would save an estimated $11 billion over the period 1981-1986 (see Table 8). If it were first implemented for the June 1982 benefit adjustment, however, it could raise costs over the period, since projections of falling interest rates could mean that the annual increase in the modified index will be higher than that for the CPI in 1982. If this index were implemented in place of the CPI in 1981, there would still be a need for interfund borrowing or some other short-run option over the 1981-1986 period. 4/

It should be noted that estimates of the potential savings from the use of this index, and the others discussed below, are highly uncertain. These indexes can fluctuate in ways that are difficult to forecast. Results such as those presented here must therefore be interpreted as tentative.

The PCE Chain Index

Some analysts see merits in using the Personal Consumption Expenditure (PCE) "chain index" in place of the CPI as an adjustment mechanism. The PCE chain index has roughly the same coverage as the CPI and uses a rental-equivalence measure for housing costs. The PCE chain index also uses current consumption patterns as weights instead of the 1972-1973 patterns used in the CPI.

As can be seen from Tables 7 and 8, the immediate substitution of the PCE for the CPI in determining the annual Social Security cost-of-living increase would also help with the short-run financing problem. Current

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4/ This and the following discussion on indexation assume that all of the savings from both the OASI and DI programs generated from various indexing options can be allocated to the OASI fund.

projections show the yearly PCE increases at approximately the same levels as the rental equivalent index. A June 1981 cost-of-living increase using the PCE index is estimated to be 10.3 percent, 1.7 percent below the expected increase of 12.0 percent if the CPI were used. This would save more than $2.4 billion by 1982. On the other hand, the relationship could reverse in future years; if so, no savings might occur. The PCE would not entirely eliminate the need for other options to help solve the short-term problem. 5/

A Price-or-Wage Index Adjustment

Another option is to limit the annual cost-of-living increase either to the rise in the CPI or to a wage index, whichever is lower over the given period. A modified approach of this type was presented by the National Commission on Social Security in its preliminary recommendations. Their proposal would also allow a "catch up" increase in benefits to compensate for past limits on benefit increases that occurred in times of falling real wages. This compensation would be made in subsequent periods when wages begin again to rise faster than prices. The catch up is not assumed in the analysis presented here, however.

During the two most recent recessionary periods, average money wages have not grown as fast as prices; that is, the real purchasing power of workers has declined. Over the last recessions, Social Security benefits have been protected against this decline in real purchasing power, since the automatic benefit increases have been greater than the growth in money wages. This relationship occurred during the 1974-1975 recession and was repeated during the current economic slowdown.

The savings to be realized from indexing benefits according to the lower of wage or price growth is substantial. If benefit increases were limited to the lower adjustment mechanism, savings of $26 billion would accrue to the trust funds by 1986. There would also be added interest income resulting from these higher balances.

Chosing the lower of a wage or price index would prevent retirees from gaining relative to active workers in times of falling real wages. It would also maintain retirees' real levels of benefits in times of rising real wage, although if benefits were previously indexed to wages, this would be at a new lower level of real benefits. Because wages over the working life of an individual are anticipated to increase faster than prices for most years,

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5/ The difference between the PCE chain index and the CPI is also extremely difficult to forecast; the results presented should be understood as tentative.

indexing benefits to the lower of wages or prices would result in a slow decline in the relative position of Social Security recipients compared to current law price-indexed benefits.

Capping the Annual Cost-of-Living Adjustment

Another possibility is for the Congress to continue to allow indexation with the CPI, but explicitly to review the increase each year. This option could operate in a manner similar to the current Congressional review of the President's determination of the federal pay raise. A Social Security benefit increase based on the CPI would be established by the end of April each year. The increase could automatically become the rate of the benefit increase unless the Congress wished to adjust it, and this approach would explicitly permit the adjustment.

The Congress might, for example, want to limit, or "cap," the cost-of-living increase at 67 percent or 85 percent of the CPI in each year in the 1981-1986 period. 6/ The effects of these choices, as well as the resulting savings, are shown in Tables 7 and 8. The 67 percent cap, commencing in 1981, would yield savings of more than $96 billion over the 1981-1986 period for the OASI and DI trust funds together. Even though this option would yield large yearly savings in the out years, the OASI fund would need additional money in the more immediate future. Thus, this option alone would not immediately generate enough money to solve the funds' short-term problem entirely. However, these savings would put the fund in a position to meet its obligations through the end of the 1981-1986 period. The 85 percent cap would save more than $44 billion.

Although caps of 67 percent or 85 percent on CPI increases in benefit payments are somewhat arbitrary, a number of precedents and justifications can be cited. The President sometimes caps federal pay raises, for example. The actual pay increases differ from what are thought to be fair comparibility increases. In 1980, the Advisory Committee on Federal Pay determined that the October 1980 raise should average 13.5 percent. The actual pay raise was 9.1 percent, 67 percent of what it might have been. This is one limit that could be applied to Social Security, although the cap on federal pay raises undoubtedly would be different in the future.

6/ The 67 and 85 percent caps should be understood as examples of potential limits and the savings resulting from them, and not as suggestions of what an exact cap, if any, should be.

TABLE 7. ESTIMATED RATES OF INCREASE OF ALTERNATIVE SOCIAL SECURITY BENEFIT INDEXING MECHANISMS, TO 1986 a/: IN PERCENTS

Year	CPI (Current Law)	Rental Equivalent Modified Index	PCE Chain Index	Hourly Earnings for Non-Farm Workers	67 Percent Cap on CPI	85 Percent Cap on CPI
	(Increase by End of First Quarter)					
1981	12.0	10.3	10.3	9.1	8.0	10.2
1982	8.9	9.9	9.9	9.1	6.0	7.6
1983	9.4	9.0	9.0	9.3	6.3	8.0
1984	9.3	9.1	9.1	9.5	6.2	7.9
1985	9.2	9.2	9.2	9.5	6.2	7.8
1986	8.9	8.8	8.8	9.5	6.0	7.6
Average Annual	9.61	9.38	9.38	9.33	6.45	8.18

SOURCE: Based on CBO's preliminary economic assumptions.

NOTE: Index figures shown here are intended solely as illustrations for comparison.

a/ Percent increases in first-quarter index from that of preceding year.

There may be substantial economic consequences of denying across-the-board limits on cost-of-living increases. In times of high rates of inflation, the full benefit adjustment may hamper efforts to slow the continued growth in prices. A relatively large increase in spending would fuel additional price increases; caps of the type discussed above would tend to help slow the rate of growth of prices. However, the amount of the cap would be determined annually by the Congress, reinstating an ad hoc component to future cost-of-living adjustments. (Although these arguments directly relate to the 67 or 85 percent cost-of-living limits, they can apply equally to the other ways of limiting the benefit increase.)

TABLE 8. ESTIMATED ANNUAL AND CUMULATIVE SAVINGS TO OASI AND DI TRUST FUNDS FROM ALTERNATIVE BENEFIT ADJUSTMENT MECHANISMS, TO FISCAL YEAR 1986: IN BILLIONS OF DOLLARS

Year	OASDI Outlays Under Current Law	Rental Equivalent Modified Index	PCE Chain Index	Lower of Price or Wage Index	67 Percent Cap on CPI	85 Percent Cap on CPI
1981	140.1	-0.5	-0.5	-0.9	-1.3	-0.6
1982	160.9	-1.9	-1.9	-3.8	-6.3	-2.8
1983	179.7	-1.2	-1.2	-4.4	-11.4	-5.2
1984	200.7	-2.0	-2.0	-5.1	-17.8	-8.2
1985	224.0	-2.4	-2.4	-5.6	-25.3	-11.7
1986	250.1	-2.8	-2.8	-6.3	-34.1	-16.0
Cumulative		-10.8	-10.8	-26.1	-96.2	-44.5

SOURCE: Based on CBO's preliminary economic assumptions.

NOTE: Minus sign denotes amount of yearly savings.

Opponents of such limits argue that incomes of Social Security recipients are below those of persons still in the work force; many retired Social Security beneficiaries are already less able to cope with increases in the cost of living. Although many recipients have some additional income from sources other than Social Security, such income rarely increases with inflation. Thus, even with fully indexed Social Security benefits, the total incomes of many recipients do not keep pace with the cost of living. Furthermore, this change would mean abandoning a commitment made by the Congress in 1972 to protect the elderly and disabled fully from the impact of inflation, however it is measured. Finally, reductions in Social Security indexing would lead to increased spending for other federal programs that are means tested. For example, expenditures for Supplemental Security Income or food stamps would rise, offsetting some of the spending reductions in Social Security. These outlays would not, however, come from the Social Security trust funds.

REDUCTION OR ELIMINATION OF CERTAIN BENEFITS

Options to modify Social Security benefits have been included in recent budgetary proposals of the Carter Administration. Although many of these cuts may be desirable for other reasons, none would generate enough savings to reverse the projected short-run OASI deficit. They could, however, serve a useful purpose if enacted in combination with other measures.

Options involving the cancellation of certain benefits include phasing out students' and certain parents' benefits and eliminating the minimum and lump-sum death benefits (see Table 9). These payments continue to come from the OASI and DI trust funds, despite the creation and expansion of other government programs more directly targeted toward the groups now eligible for these benefits. Some of these awards are not directly tied to tax contributions. Furthermore, changing labor-force patterns of women may have made obsolete some Social Security provisions. Many such benefits could, in addition, be rescinded quite quickly.

Both the Ford and the Carter Administrations recommended phasing out Social Security post-secondary student benefits, which are payable to unmarried dependents between the ages of 18 and 22 who are full-time students. (Nonstudent child dependents' benefits stop at age 18.) The entitlement was created in 1965 legislation and since that date the Congress has greatly expanded other forms of student assistance since 1965. In particular, the Basic Education Opportunity Grants (BEOGS) program has been implemented. Phasing out the Social Security benefit would thus eliminate some duplication of aid. There would be, however, some offsets in these savings to the general budget as a result of taking this option, since there will be some additional BEOGS payments to compensate lower-income recipients of Social Security student benefits.

In his 1980 budget, President Carter proposed phasing out the survivor benefits for parents of children aged 16 and 17. In addition, eliminating the minimum benefit for new beneficiaries, and the lump-sum death benefit for surviving families was also proposed. None of these proposals was enacted by the Congress.

Survivors' benefits for parents are paid until their children reach age 18. If the parents' benefits (but not the children's) were discontinued when the dependents turned 16, annual savings to the trust funds would exceed $500 million by 1986. Such a change would be based on the assumption that parents--primarily mothers--of children aged 16 or 17 are not homebound and can join the labor force. At present, however, more than half of all women whose youngest children are older than 13 are already in the work

TABLE 9. PROJECTED SAVINGS FROM REDUCING OR ELIMINATING CERTAIN SOCIAL SECURITY BENEFITS, TO FISCAL YEAR 1986: IN MILLIONS OF DOLLARS

Benefit Change	1982	1983	1984	1985	1986
Phase Out Student Benefits	650	1,235	1,820	2,480	2,710
Phase Out Survivor Benefits for Parents of Children Aged 16 and 17	25	90	500	525	535
Eliminate Minimum Benefit	65	135	160	205	225
Eliminate Lump Sum Death Benefit	400	410	420	435	450
Cumulative Savings	1,140	1,870	2,900	3,645	3,920

SOURCE: CBO estimates.

force. On the other hand, many such women have no recent work experience and may not be able to find jobs, especially in times of high unemployment. Furthermore, for those who are employed, many have low incomes, especially relative to previous total family incomes.

When a worker has been employed intermittently in jobs covered by Social Security, the benefit he would receive under the present benefit computation method could be very low. To compensate for the low benefits, the Congress had stipulated that there be a minimum monthly benefit. Under the 1977 Social Security Amendments, this minimum amount was frozen for most new retirees at $122 per month (except for certain special minimum benefits).

Although most persons receiving the minimum are women whose labor-force attachment covered only part of their potential working lives, many retirees who spent most of their working careers in noncovered employment, typically in government, also receive the minimum benefit. Some in the group who are eligible for the minimum benefit have earned pensions under other programs. Proposals have been put forth to eliminate this minimum benefit completely for newly retired workers. Persons actually in need could be directly protected by Supplemental Security Income (SSI) and other assistance programs; elimination of the minimum benefit could therefore lead to significant increases in spending elsewhere in the budget.

A lump-sum benefit (to a maximum of $255) is paid to survivors of deceased retired and disabled workers. This benefit goes either to the family, or, in the case of no immediate surviving family, to the institution or agency last caring for the beneficiary. The benefit is meant to defray part of the cost of burial, although the maximum payment allowed has not been increased since 1954. Proposals to eliminate this benefit could save approximately $400 million in fiscal year 1982. If this proposal created a financial hardship on some low-income families, the SSI or other assistance programs could serve as an alternative source of aid.

Proposals to cut or phase out benefits of any sort would inevitably give rise to controversy. These benefit options may, however, be programmatically desirable in the short run. They could help--to a limited degree--with the short-run financing problems and could save significant sums of money in the longer term. However, only larger benefit reductions or limits on the amount of future benefit increases could ensure the trust funds' short-term solvency without creating needs for concurrent tax increases or accounting changes.

INCREASING REVENUES TO THE TRUST FUNDS

As an alternative to accounting changes or benefit reductions, payroll taxes could be raised further, or revenues could be introduced from outside sources to maintain the trust fund balances at an adequate level. There are a number of ways to do this. The Congress might grant Social Security the authority to borrow from the federal Treasury when economic conditions are depressed. These loans could be repaid later, when the trust funds have a surplus. Alternatively, these general Treasury monies might be regarded as a form of countercyclical federal aid that would not have to be reimbursed.

Another option might be to finance all three trust funds, or the HI fund separately, with individual and corporation income tax receipts. A portion of income tax revenues could be earmarked for Social Security and used to replace part of payroll tax collections. Alternatively, payroll taxes could be raised still further, and credits for payroll tax contributions could be used to offset income tax liabilities.

Countercyclical Borrowing

Most proposals involving lending from the federal Treasury suggest using a measure such as the unemployment rate as a trigger mechanism. 7/ Such schemes have the advantage of avoiding payroll tax increases precisely when payroll tax revenues have slackened because of an economic slowdown. A drawback to most of these approaches, however, is the length of time for which these loans are likely to remain outstanding. In this respect, borrowed funds, because they are unlikely to ever be fully repaid, would resemble outright grants.

Another shortcoming to using the unemployment rate as a trigger to permit borrowing is the change in recent years in the definition of full employment. A decade ago, an unemployment rate of 5.5 percent reflected an economy operating far below peak capacity. Now, changes in the composition of the labor force indicate to some analysts that an unemployment rate between 5 and 6 percent can be defined as full employment. Further shifts in demography, or simply in definition, would limit the usefulness of any single economic indicator as a trigger for countercyclical borrowing.

Finally, whether funds from outside the system were transferred on a loan basis or as outright grants, the inevitable effect of borrowing would be either a reduction in the amount of money available for other federal programs or an expansion of the deficit. In the past, the Congress has found it difficult to slow increases in expenditures, since a large fraction of federal outlays (including Social Security) are regarded as relatively "uncontrollable". If other federal programs are not cut accordingly, the federal deficit would grow, in turn triggering a rise in the price level. This could cause Social Security expenditures to rise still further. If such an outcome were to be avoided without other federal program cuts, the Congress might have to turn to other sources for increased Social Security revenues.

Payroll Tax Increases

In keeping with past practice, a way to assist the OASI trust fund would be to raise either the payroll tax rate or the maximum taxable wage base over and above the increases now in effect and scheduled for future years according to the 1977 amendments. Ensuring that the trust fund balances remain above 9 percent of future outlays would require a payroll tax rate increase of at least 0.5 percent above current rates starting in 1982, or eliminating the ceiling on the taxable maximum wage base, and earmarking all the additional revenue for the OASI trust fund.

7/ For a similar recommendation, see Social Security Financing and Benefits, Report of the 1979 Advisory Council on Social Security (December 1979), pp. 51-54.

A payroll tax increase of 0.5 percent, which would bring the scheduled 1982 rate from 6.7 to 7.2 percent for both employers and employees, would raise Social Security revenues by a total of more than $25 billion in fiscal years 1982 and 1983 (see Table 10) and by more than $80 billion over the period 1982-1986. These new monies, however, would be just barely adequate to put the OASI fund in a position to meet its obligations. If instead the rate were raised by a full of 1.0 percent, the added revenues would double, giving the system a greater cushion against economic shocks.

Removing the ceiling on taxable earnings and taxing all earned income would achieve roughly the same result by 1986 as instituting a 0.5 percent payroll tax increase if the additional revenues were directed to OASI. Critics of this approach contend that persons whose incomes now markedly exceed the taxable wage base would bear a disproportionate share of the cost of Social Security. In response to this argument, some analysts have suggested that the ceiling be lifted off only the employers' share of the tax. This proposal is justified on grounds that employers can deduct their tax liabilities as business expenses, whereas employees have no such advantage. Such a compromise measure would generate roughly $34 billion in new payroll tax revenues through 1986, which is still short of what the OASI fund is assumed to require. 8/

Altering the tax treatment of self-employed persons, whose present payroll tax rate of 9.3 percent is set midway between the employees' and the total employer/employee rates, is another possibility. Raising the levy on self-employed persons to match the full employer/employee rate (13.4 percent in 1982) could generate $20 billion in new revenues through 1986. 9/

An Offsetting Tax Credit

Increases in the payroll tax have drawn objections as having both inflationary and restrictive economic effects. An increase in the employers' share of the Social Security tax would raise a firm's labor costs and thus

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8/ Because employers' payroll tax payments could be deducted against corporations' income tax liabilities, however, corporation income tax revenues would decline.

9/ The Carter Administration made such a proposal to deal with the so-called "independent contractor" issue, in which certain employers attempt to reduce their F.I.C.A. tax liabilities by not claiming employees as such but by defining them rather as providers of purchased services. Self-employed persons would have been permitted to deduct half of their contributions against their income tax liabilities.

could contribute to the higher levels of prices and unemployment. Many analysts believe that the employer-paid portion of a payroll tax increase, to the extent that it is not offset by lower wages or lower employment, would eventually be reflected in higher prices for goods and services. In the context of Social Security in particular, such inflationary effects have direct bearing on outlays, inasmuch as they would inevitably be reflected in benefit amounts. Increases in the employees' share of the tax would tend to cut into disposable income, causing a decline in aggregate demand that, in turn, might result in higher unemployment. 10/

To lessen the detrimental effects of a tax increase but at the same time meet the projected deficit in the OASI fund in 1982, the Congress could increase the payroll tax but moderate the impact by enacting an income tax credit or a deduction for payroll tax contributions. A bill introduced in the 97th Congress, S. 44, is intended to do approximately this. To help offset a rise of almost 10 percent in the payroll tax in 1981 and 1982, S. 44 would provide a refundable income tax credit of 10 percent for employer and employee payroll tax contributions made in those years. 11/ (The amounts by which such a credit would lower income tax revenues, if it were enacted on a permanent basis, are given as a note to Table 10.)

When likened to other kinds of income tax cuts, the credit proposal would direct a larger portion of the income tax reduction toward low-income taxpayers and would favor industries with higher labor costs. Because of its tie to Social Security coverage, certain portions of the taxpaying public would not realize any benefits from the credit--most notably Social Security beneficiaries themselves. An estimated 5 to 6 million taxpayers over age 65 might be left out of the cut. The 10 percent of the working population not covered by Social Security would also not benefit.

The earned income credit (EIC) was enacted (in 1975) to help offset the effect on low-income taxpayers of higher payroll taxes. A payroll tax credit could be viewed as an extension of the EIC, offering similar work incentive effects. The full effect of the credit's work incentive features would be felt by persons whose entire earnings fell below the Social Security income ceiling--the great majority of wage-earners.

10/ Such an outcome, however, would mitigate an increase's inflationary effects. For analysis of the effects of the payroll tax on different spheres of economic activity, see CBO, Aggregate Economic Effects of Changes in Social Security Taxes (August 1978).

11/ Unlike many other kinds of tax credits, credits in excess of income tax liability for a "refundable" credit are paid in cash.

A drawback to the credit is the complexity it would add to the income tax structure. For most taxpayers, this problem could be mitigated by incorporating the credit into withholding schedules. For low-income persons, however, experience with the refundable EIC has shown that low-income people who would not normally file tax returns might fail to take full advantage of the credit's refundability provision. Further difficulties might arise in devising a method for reimbursing state and local governments and not-for-profit organizations for contributions made on their behalf.

General Revenue Financing of HI

Both the 1979 Advisory Council on Social Security and the National Commission on Social Security have proposed a reduction in the overall payroll tax rate, to be achieved by financing HI out of earmarked individual and corporation income tax revenues. Of the three Social Security programs funded by the payroll tax, HI has been singled out for removal from the payroll tax framework because its benefits are unrelated to a person's past earnings. Unlike the expected benefits a person receives under OASI or DI, which are closely tied to the level of past contributions, HI expenditures are based exclusively on the need for medical care. In addition, a precedent has already been established for such a change by the funding of the other portion of Medicare, Supplemental Medical Insurance, some two-thirds of which is now financed from general revenues.

Financing HI from a surtax on income tax liabilities earmarked for HI would allow part of the HI share of the payroll tax to be shifted to the OASI and DI portions of the tax rate and part to be used for a reduction in the overall payroll tax rate. Table 10 shows the amount of additional payroll tax revenue the OASI and DI funds would receive if HI were entirely financed by income tax collections while the overall payroll tax rate was held at its 1981 level until 1986. (A bill, H.R. 1018, introduced in the 97th Congress, would achieve a similar result by funding half of HI from general revenues and setting the combined OASDHI rate at 6.55 percent.) Like the tax credit described above, this approach would neutralize the potentially adverse effects of future payroll tax increases by replacing payroll tax contributions with income taxes. On the other hand, workers not covered by Social Security, as well as current beneficiaries, would be required to pay for a portion of the program. As with the tax credit, labor costs would decline as the payroll tax rate fell, thus providing employers with greater incentive to hire additional employees. A surtax might also result in fewer administrative problems, since the procedures for determining tax liability would not change. This approach, unlike a payroll tax increase, would also tend to benefit low-income taxpayers more than more affluent people by guaranteeing a tax cut for low-income taxpayers.

TABLE 10. PROJECTED EFFECTS OF REVENUE CHANGES TO ASSIST THE OASI TRUST FUND, a/ TO FISCAL YEAR 1986: IN BILLIONS OF DOLLARS

Change	1982	1983	1984	1985	1986
Increasing Payroll Tax by 0.5 Percent b/	10.0	15.6	17.5	19.5	21.8
Eliminating the Ceiling on Taxable Earnings b/	5.4	16.9	18.5	19.6	21.0
Raising the Self-Employed Tax Rate to the Full Employer/Employee Rate c/	0.8	3.9	4.4	5.0	5.7
Reallocating the HI Portion of Payroll Tax Rate to OASDI d/	24.9	38.5	43.2	39.7	40.7
Inflation-Induced Income Tax Revenues e/	11.9	39.0	75.1	121.0	179.1

SOURCE: Joint Committee on Taxation and CBO estimates.

NOTE: Proposed changes assumed effective January 1, 1982. Figures do not include any revenue offsets that might result from a payroll tax change. Most of these offsets are likely to come from changes in income tax payments.

a/ Assumes current law. For estimated amounts needed, see Table 5.

b/ As an offset to these payroll tax increases, a refundable 10 percent credit would reduce income tax revenues over the period by the following yearly amounts: $12.1 billion, $19.7 billion, $22.1 billion, $25.7 billion, and $29.4 billion.

c/ Disregards income tax reduction caused by deductibility provision for half of payroll tax contributions.

d/ Calculated by transferring a portion of HI rate to OASI and DI and fixing the combined OASDI rate at the current 6.65 percent rate.

e/ Based on currently scheduled tax rates. Assumes allocation of a portion of inflation-induced increases in revenues to go to OASI fund.

Inflation-Induced Increases in the Income Tax

During periods of inflation, federal income taxes tend to rise more rapidly than individual incomes because of the federal income tax code's progressive features. 12/ Under current policy, for example, additional individual income tax receipts attributable to inflation in a single year are likely to grow from $11.9 billion in 1982 to $179.1 billion in 1986 (see Table 10). In the past, the Congress has acknowledged these unlegislated tax increases by enacting periodic tax cuts designed in part to offset inflation's effects. If it seems advisable to forego or reduce the size of these income tax cuts, a portion of the resulting revenues could be directed to the trust funds by either earmarking them or making general revenue transfers. Many advocates of the Social Security program express a preference for allocating the funds explicitly, because they feel that this transfer arrangement would be more binding. They argue, in addition, that earmarking gives administrators greater control over program expenditures, although evidence from the DI and HI programs suggest that specific earmarking has little effect on program costs.

A shift in the method of funding Social Security would affect the overall distribution of the federal tax burden. Under current law, the payroll tax in 1981 is levied at a fixed rate on all wages and salaries up to the specified earnings ceiling of $29,700. The average payroll tax rate on adjusted gross income therefore remains fairly constant for incomes below the wage limit and declines for incomes above it (see Table 11). The distribution of individual income tax liabilities, on the other hand, is fairly progressive; the fraction of income collected in taxes rises with income, in accordance with ability to pay.

How taxpayers in different economic circumstances would fare under a combined income and payroll tax to finance Social Security is uncertain. For example, the Congress could decide to obtain additional revenue by doing without an inflation-offsetting tax cut and assigning the increases in individual income taxes to Social Security, as outlined above. Between 1967 and 1977, the Congress enacted income tax cuts that tended to overcompensate low- and middle-income persons for inflation. If the Congress decided to forego this kind of tax reduction in the future, the resulting distribution of individual income and Social Security taxes then would be roughly similar to the effects of the existing system. The Congress would be foregoing an income tax cut benefiting mainly low- and middle-income taxpayers but averting an alternative tax increase that would have fallen mainly on those same taxpayers.

12/ For a detailed discussion of inflation's effects on individual income tax liabilities, see CBO, Indexing the Individual Income Tax for Inflation (October 1980), Chapter II.

TABLE 11. COMPARISON OF THE DISTRIBUTION OF THE SOCIAL SECURITY PAYROLL TAX AND OF THE INDIVIDUAL INCOME TAX UNDER CURRENT LAW, BY INCOME CLASS

Income Class (in Dollars)	Payroll Tax Contributions: Percent of Total Paid by Each Income Class	Payroll Tax Contributions: As a Percent of Adjusted Gross Income	Income Tax Liability As a Percent of Adjusted Gross Income
Below 5,000	3.2	7.5	0.7
5,000 - 10,000	7.5	5.5	5.4
10,000 - 15,000	10.3	5.7	9.9
15,000 - 20,000	12.6	6.0	12.2
20,000 - 30,000	27.7	6.0	14.1
30,000 - 50,000	29.4	5.5	17.1
50,000-100,000	7.7	3.4	23.5
100,000-200,000	1.3	1.7	32.5
Over 200,000	0.3	0.7	39.9
	Total 100.0	Average 5.2	Average 15.9

SOURCE: Joint Committee on Taxation.

The Revenue Act of 1978, however, reversed the distributional pattern of the previous 10 years by providing relatively greater tax benefits to upper-middle- and high-income taxpayers. Foregoing this kind of tax cut and transferring the additional tax revenue to Social Security would effectively make the combined income and payroll tax more progressive, since a payroll tax that would fall primarily on low- and middle-income taxpayers would be averted by denying a tax cut to higher-income taxpayers.

SOME OPTIONS IN COMBINATION

As emphasized above, some revenue or benefit options alone would probably be insufficient to ensure benefit payments throughout the coming five years. Some, such as the accounting changes outlined early in this chapter, would allow benefits to be paid for an additional two or three years before other action is needed. Other options taken together, though, could be sufficient to relieve the system's financial difficulties for longer periods.

If the Congress selected any of the accounting changes to ease the OASI fund over its immediate critical period, further infusions of $3.5 billion and $4 billion would be needed in fiscal years 1984 and 1985. An additional $1 to $2 billion would be needed by 1987. After that, the OASI fund should be able to meet its obligations through 1990. In interpreting these estimates, however, one must assume that the economy will behave in the manner now anticipated. If there is a repetition of past cyclical behavior, even these additional monies could prove inadequate.

All four benefit reductions discussed above, combined with one of the accounting changes, could generate enough savings to ensure continued and timely payment of benefits. Combining accounting changes with any of the options involving the indexing mechanism could offer the same assurance. A combination of capping benefit increases at 67 percent of the CPI and of a one-percentage-point increase in the payroll tax would provide a larger trust fund cushion against unanticipated events.

CHAPTER IV. CHANGES FOR THE LONGER TERM

A number of options that would entail more fundamental changes in the structure of the Social Security system have been put forth. Several of these plans could at least help in solving OASI's short-term financing difficulties, although drawbacks accompany the advantages of each. The discussion below focuses on two such structural changes: that all paid workers participate in the Social Security system (that is, requiring universal coverage), and that OASI and DI benefits be treated as taxable income.

UNIVERSAL COVERAGE

Universal coverage, as the term implies, would require that Social Security coverage be extended to workers now excluded from the system--about 10 percent of the labor force. 1/ In the past, efforts to mandate universal coverage have been sparked by two concerns. First, persons whose work experience includes a mix of employment in jobs both covered and not covered by Social Security might fail to qualify for retirement benefits altogether, because of lack of coordination between different retirement systems. Second, other persons might receive overly generous Social Security payments on top of other retirement benefits; this could occur because the Social Security benefit formula is structured to provide a more generous return to persons making smaller contributions, and it does not distinguish between workers with low lifetime wages and those employed only part of their working lives in covered positions.

More recently, increases in the Social Security tax rate and base have caused a number of state and local government employers to opt for withdrawal from the system. These actions have increased pressure to alter the elective nature of the program for state and local government workers (as well as for certain workers in not-for-profit organizations), especially since many government workers who would leave the system have earned

1/ For analysis and data, see Universal Social Security Coverage Study Group, The Desirability and Feasibility of Social Security Coverage For Employees of Federal, State and Local Governments and Private, Non-Profit Organizations, (March 1980). Also see reports of the 1979 Advisory Council on Social Security and the interim report of the National Commission on Social Security.

sufficient credits in covered employment to entitle them to Social Security benefits upon retirement. But the legal complexities of requiring state governments to pay taxes for a federal program have inhibited the development of proposals to include noncovered employers.

A number of ways of incorporating noncovered workers have focused on civilian federal employees. One option would be immediately to include all such federal workers, but without merging the Civil Service Retirement (CSR) fund with Social Security's funds. Such an approach, if implemented, would raise Social Security's tax revenues by about $6.8 billion in fiscal year 1982, and by a total of $54.6 billion through the end of fiscal year 1986. Though not stipulated in the proposal, retirement credits and contributions could be transferred between the Social Security and CSR trust funds, with civil service retirement benefits still being paid out of the CSR fund. Most of these payments now are appropriated from general revenues, and they would continue to be so.

Other proposals designed to broaden coverage take a more incremental approach. One such option, advanced by the 1979 Advisory Council on Social Security, would incorporate only newly hired employees of federal, state, and local governments and not-for-profit organizations. A more limited option would bring only newly hired federal workers into the system. Proponents of such gradual approaches point to them as ways to minimize the administrative complexities of merging various retirement systems and of extending "hold-harmless" protection to older employees. 2/ The principal arguments against such options are that these approaches would be unfair to federal workers; and, in addition, their potential impact on the short-run financing problem of the Social Security system would be too slight and would take too long to be felt.

The Advisory Council's recommendations do not address the administratively complex questions of integrating the two retirement systems' benefit levels, establishing eligibility requirements, or setting employee contribution rates. Nor do they consider the potential effects on the CSR fund. With assets exceeding $70 billion in 1981, the CSR fund now appears strong. But without compensatory revenue provisions, incorporating civil service workers into Social Security would diminish the CSR fund's income. The effect of implementing this option would be to transfer part of Social Security's current problem to the civil service retirement system.

2/ Hold-harmless provisions are designed to tide over beneficiaries of old, superseded aid programs while new plans are being implemented.

TAXATION OF BENEFITS

Administrative rulings made by the Internal Revenue Service in the early stages of the program have served as a basis for treating Social Security benefits as tax-exempt income. In the 1940s, however, retirement income supplemented by Social Security was far lower than it is today. In view of the currently projected difficulties in the Social Security trust funds, some observers have suggested shifting a portion of the payroll tax burden to beneficiaries themselves by taxing some part of OASI and DI benefits, rather than lowering the level of benefits across the board or raising Social Security taxes on the current generation of workers. The income tax revenues collected on benefits could be assigned to the trust funds, although an allocation mechanism would have to be developed.

Several variations of this proposal have been advanced. These include taxing half of all benefits or taxing the benefits of recipients whose total retirement incomes exceed certain levels. The rationale for taxing half of the benefits is twofold. First, employees already pay income taxes on the portion of their earnings that is also subject to Social Security taxes; employers' contributions are treated as a tax-deductible business expense and therefore escape taxation. Thus the half of OASI and DI benefits financed by employer taxes could be treated as taxable income. Second, the 1979 Advisory Council on Social Security found that, if the tax rules now applying to private pensions were also applied to Social Security, considerably more than half of all OASI benefits would be taxed, although the portion that would be taxed would vary.

Taxing half of benefits would very roughly approximate the present tax treatment of pension income and would avoid certain administrative complexities. By including Social Security benefits as part of taxable income, benefits would be taxed according to the ability-to-pay criteria that determine the federal income tax schedule. Households that are more dependent on Social Security income would have to forego a smaller portion of this income than would more affluent taxpayers. Analysis of this proposal's effect on OASI beneficiaries' tax liabilities shows that about 60 percent of current recipients would have paid roughly $17 more if the provision had been implemented in 1980 (see Table 12). More well-to-do beneficiaries would have experienced considerably larger tax increases, however--people with incomes between $50,000 and $100,000 would pay more than $1,000 in additional taxes per year. In the aggregate, though, taxing half of benefits would generate relatively small amounts of new revenue compared with the present needs of the Social Security system. For example, it is estimated that, in 1982, including half of OASI payments as part of taxable income would result in about $6.7 billion in additional revenues. By 1986, this figure would approach $13.4 billion.

TABLE 12. INCOME TAX LIABILITIES OF OASI RECIPIENTS UNDER CURRENT LAW AND TAX INCREASES RESULTING FROM TAXATION OF HALF OF OASI BENEFITS IN 1980, BY ADJUSTED GROSS INCOME CLASS

Income Class a/ (in Dollars)	Percent of All OASI Beneficiaries Filing Returns	Average Income Tax Liability Under Current Law (in Dollars)	Average Tax Increase Attributable to Tax on Half of OASI Benefits for 1980 (in Dollars)
Less than 4,000	59.9	-4 b/	17
4,000-10,000	20.1	214	305
10,000-20,000	13.1	1,440	443
20,000-30,000	3.8	3,446	594
30,000-50,000	2.3	6,891	751
50,000-100,000	0.7	17,697	1,070
Above 100,000	0.1	42,967	1,963
Total	100.0	Average 677	Average 178

SOURCE: Congressional Budget Office estimates.

a/ Includes income from OASI benefits.

b/ Liability is negative because of refundability provisions of earned income credit.

A more limited approach would be to tax half the benefits only for persons whose incomes rise above certain stated limits. The amounts of revenue to be generated by these kinds of proposals, though, would be considerably smaller than taxing half of all benefits. For example, if Social Security benefits were treated according to rules that apply to unemployment compensation, the additional revenue resulting from the tax would amount to \$1.6 billion in 1982 and \$4.6 billion by 1986. 3/

OTHER LONG TERM POSSIBILITIES

Certain other issues could arise over the next decade that might affect or be affected by potential short-term solutions to the trust fund problem. These could involve altering the benefit formula, implementing a multi-tiered benefit structure, increasing the retirement age, and adopting earnings sharing among married persons. In addition, some thought might be given over the next decade to a gradual lowering of the replacement rate for new beneficiaries.

These are among issues the Congress will want to bear in mind when deliberating about the short-run options for Social Security. Alone, however, none could remedy the short-run financing problem of the system.

3/ Under a provision of the Revenue Act of 1978, for individuals with adjusted gross incomes above \$20,000 and for joint returns with incomes greater than \$25,000, unemployment compensation benefits are included as part of taxable income.

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